

THE UNITED STATES TRADE REPRESENTATIVE
WASHINGTON
20506

May 20, 1985

MEMORANDUM

TO: ROGER PORTER
FROM: MICHAEL B. SMITH, Acting
SUBJECT: Background Paper on Telecom

As you may recall, you asked me to have a three page summary prepared of the TPSC Taskforce's Study on Telecom. Attached is the summary with updated statistics to reflect trade for the full year 1984. If you need any more information, please feel free to call. Thanks

Attachment

PRINCIPAL FINDINGS OF 1984 TPSC
TELECOMMUNICATIONS TASK FORCE

The United States is the world's leader in the consumption, production, and sales of telecommunications equipment. Its technology is unsurpassed. But, its trade position is inferior to that of its principal trading partners.¹

The United States accounts for 38% of world production in telecommunications equipment, while the EC, Japan and Canada each account for 22.5%, 11%, and 4%, respectively.²

Our 1982 surplus in telecommunications equipment of over \$120 million shifted to a deficit of more than \$772 million in 1983. In 1984, our deficit more than doubled to over \$1.44 billion.³ In 1983, our major trading partners -- Japan, the EC, and Canada -- had global trade surpluses in telecommunications equipment of \$1.25 billion, \$935 million, and \$343 million, respectively.

-- The reason for the less impressive U.S. performance in the international trade of telecommunications equipment is not the level of U.S. technology relative to other suppliers or the underlying growth of the U.S. telecommunications sector. We are unsurpassed in digital switch, microwave, lightwave, and satellite technology. And, the telecommunications market in other parts of the world has generally grown as fast as the U.S. market. However, in low technology equipment such as hand-held sets, key telephone systems, and facsimilies, we are at a price disadvantage.

-- The inferior U.S. trade position is due to the following factors:

- o The unilateral opening of the U.S. telecommunications market beginning with the 1968 Carterfone decision and culminating with the 1982 Consent Decree has increased competition, both domestic and foreign, for equipment sales to private customers and regional telephone companies. Those actions were taken without consideration for their international trade effects.

- o Through their postal telephone and telegraph companies (PTTs) and other public entities, most foreign govern-

¹For the purposes of this description, we will discuss only the markets for the United States, Japan, the EC, and Canada because these four entities account for almost 80% of worldwide apparent consumption. This aggregation is analytically sound and simplifies the presentation of massive amounts of data.

²Trade data include only extra-EC trade.

³Trade data based on 1984 ITC definition of telecommunications.

ments direct the purchase of telecommunications equipment to domestic suppliers. Purchases by these public entities are not as sensitive to price considerations as purchases by private entities because they often are influenced by non-market, sometimes political, considerations. Moreover, PTT purchases are not covered by the Government Procurement Code; hence, they can be made on a non-MFN, discriminatory basis. PTT's typically account for about 60% of a country's telecommunications market and influence the other 40% (end-user purchases of terminal equipment) through certification and approval procedures. As a result, most of the world market outside the United States remains closed to traditional market competition.

- o Other countries have been more aggressive than the United States in promoting telecommunications equipment exports through their export financing banks.

- o And, the high value of the dollar has helped make foreign telecommunications equipment more price competitive in the U.S. market.

- o Historically, U.S. firms were not challenged by foreign firms in our market and were not export-oriented. In a 1922 Consent Decree, AT&T was forced to divest ITT and was prohibited from engaging in overseas business.

- Telecommunications companies sell to foreign customers through foreign subsidiaries, at least in part to get around market distortions created by government intervention. For example, European subsidiaries of U.S. companies generated over \$3 billion in revenues in 1983, while we exported only \$295 million in telecommunications equipment to Europe. U.S. companies are also well invested in Canada. And Japanese, Canadian, and European firms have considerable investments in the United States.

-- In 1984, the U.S. deficit with Japan was over \$1.2 billion. This is nearly double our 1983 deficit of \$674 million which was 70% higher than our 1982 deficit of \$395 million. Japan is the largest source of imports into the U.S. market, accounting in 1983 for 45% of U.S. imports and 47% of Japan's exports of telecommunications equipment. Japan's telecommunications equipment market is and will continue to be dominated by Nippon Telegraph and Telephone Public Corporation (NTT), a private entity as of April 1 with 100% stock ownership by the Government of Japan. It controls 40% of the Japanese market for telecommunications equipment. The NTT Agreement resulted in only \$330 million in U.S. sales during the first four years of the agreement, only 20-30% of which was telecommunications equipment.

Most European Community national markets are dominated by their individual PTT's who prefer to purchase equipment manufactured within their borders. European firms face significant barriers in selling in other European markets, and, because of this, vigorously pursue export markets outside the Community. This helps explain the EC's overall trade surplus in telecommunications. In 1984, the United States had a \$240 million surplus in trade with the EC, a number substantially unchanged over the past five years.

In 1984, the United States had a trade surplus with the Federal Republic of Germany, France, Italy, and the United Kingdom of \$43 million, \$2 million, \$23 million, and \$104 million, respectively. The national PTT in each of these markets controls anywhere from 70-92% of all domestic purchases. Domestic producers, in turn, supply from 80-93% of total domestic demand for telecommunications.

In the United Kingdom, the PTT monopoly was abolished in 1981 and British Telecom, a government corporation, was formed to take charge of telecommunications services. British Telecom was privatized earlier this year. Overall, the U.K. has the most liberalized telecommunications market in Europe and appears poised to take the fastest steps toward more competition.

In 1984, we had a \$140 million deficit with Canada; a sharp increase from our \$11 million deficit in 1982. The Canadian industry is regulated at both a federal and province level. The provincial telephone companies procure locally. The Canadian Government also has publicly encouraged the private sector to "Buy Canadian" when purchasing telecommunications equipment. The second major non-tariff barrier in the Canadian market is vertical integration--Northern Telecom is majority-owned by Bell of Canada. Hence, Bell Canada buys 90% of its equipment from Northern Telecom. Canada also has a 17.5% tariff, the only major tariff barrier facing U.S. exporters in industrial countries.

Taiwan, Korea, Hong Kong, and Singapore are major exporters of customer premise equipment to the United States. While all of these countries had a surplus in telecommunications trade with the United States in 1984, their overall position is deteriorating as U.S. consumers appear to be buying fewer low-priced telephone sets. Due to their rapid rate of economic growth, these countries are large export markets for U.S. industry. No significant trade barriers exist that hinder U.S. suppliers in these markets. Often our major disadvantage in competing in these markets is the lack of export financing for U.S. suppliers compared to that offered by our principal competitor governments.

EPC
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**Administration's Position on the Danforth
Telecommunications Bill**

PROBLEM

The Danforth telecommunications trade bill poses fundamental issues for the Administration's conduct of trade policy -- it provides specific negotiating authority to open foreign telecommunications markets, but limits Presidential discretion in deciding whether and when to retaliate and in mandating sectoral reciprocity for telecommunications. The EPC must now decide whether: (1) the Administration wants such new negotiating authority specifically in telecommunications; (2) if it does, in what form; and (3) if it does not, how to frame our opposition in the least confrontational manner. This decision is, to a large extent, a matter of political judgment.

SUMMARY OF THE BILL

The bill's intent is to give the President negotiating leverage to open foreign markets for U.S. telecommunications equipment and services. Specifically, it includes two elements:

First, the bill requires the President to undertake negotiations with countries that have substantial, but partially closed, telecommunications markets to achieve "substantially equivalent competitive opportunities" ("SECO") as compared to those available to foreign suppliers in the U.S. market. To do this, the President is authorized to make concessions affecting U.S. trade in telecommunications and other products, subject to Congressional approval. If no agreement is reached within two years, the President is required to take any of seven retaliatory actions "as necessary to fully achieve" the bill's objectives, including SECO.

Second, the bill requires retaliation by the USTR against those countries which he finds have violated an agreement affecting telecommunications trade. A "violation" for this purpose includes the failure of U.S. telecommunication exports to a particular country to achieve a level "reasonably anticipated" under the trade agreement in light of the competitiveness and export potential of the U.S. industry.

Positive Elements: The bill has several positive elements, the most important of which include:

- (1) giving the President new authority to grant trade concessions in telecommunications and other areas, subject to Congressional approval on a fast-track basis;
- (2) giving the President authority to compensate countries against whom he retaliates as may be necessary under the

GATT, and

- (3) putting pressure on our trading partners, particularly Japan, to liberalize their telecommunications markets.

Negative Elements: The bill's negative elements include:

- (1) requiring the President to seek no less than sectoral reciprocity in his negotiations on telecommunications or retaliate;
- (2) effectively making telecommunications trade the President's highest negotiating priority in the sense that it would be the only sector in which he will be authorized to seek liberalization in return for U.S. concessions in other areas;
- (3) transferring the existing 301 authority to retaliate on telecommunications from the President to the USTR; and
- (4) running the risk if we retaliate that other countries would counter-retaliate thereby closing telecommunications markets both here and abroad.

LEGISLATIVE ASSESSMENT

This bill reflects growing discontent in the Senate and in the business community over the ~~Administration's trade policy~~ as it relates to telecommunications. Last year, when Senator Danforth introduced similar legislation, his colleagues and the business community showed little interest. This year, the bill has five co-sponsors (Senators Bentsen, Heinz, Inouye, Lautenberg, and Wilson). And, the industry (AT&T, IBM, GTE, and the Chamber of Commerce) now support the need for special trade legislation on telecommunications. Labor, as represented by the IBEW, feels the bill isn't tough enough. This discontent has arisen because the Administration has not retaliated against any nation, particularly Japan, for failure to open its telecommunications market. Hence, the present bill is intended to limit the President's existing discretion to decide whether and when to retaliate. If negotiations fail to open markets within two years, retaliation is mandatory.

The Administration has avoided taking a formal position on Senator Danforth's telecommunications trade bills. Last September we were asked to testify, but at the last minute declined to appear because of internal differences on the bill. These differences remain unresolved in consideration of the present bill so the Administration declined to testify on it at a May 3 hearing. An Administration position should now be conveyed to Senator Danforth as soon as possible and no later than the mark-up which is likely to occur immediately after the Memorial Day recess.

If our trade balance in telecommunications continues to deteriorate rapidly (as we expect it to), some Congressional action this session can be expected. More troublesome legislation has already been introduced. The Chafee bill, for example, prohibits imports of Japanese telecommunications equipment until the President certifies that Japan is as open as the U.S. market. Opposition to the Danforth bill could give impetus to these other bills.

KEY ISSUES

There are essentially four issues that the EPC must address in deciding what recommendations to make to the President on the Danforth bill.

1st Issue: Does the Administration want additional, sector-specific negotiating authority (i.e., authority to reduce U.S. trade barriers in exchange for market access concessions from other countries solely in telecommunications)?

This is the fundamental, philosophical issue. If as a matter of general trade policy the Administration does not want sector-specific negotiating authority, it should oppose the Danforth bill.

The President already has the authority under Section 301 to restrict a country's access to the U.S. telecommunications market as a means for creating negotiating leverage. (Such authority has never been invoked; Ed Spencer of the U.S./Japan Advisory Group has written Secretary Baker urging Section 301 action against Japan as soon as possible.) The Danforth bill enhances Section 301 leverage by giving the President additional authority to restrict access to the U.S. market and by authorizing the President to give concessions on telecommunications and other products.

The agencies disagree about the need for this additional, sector-specific negotiating authority. Some believe that accepting such authority sets a dangerous trade policy precedent in codifying sectoral reciprocity and in allowing Congress to grant negotiating authority on a sectoral basis rather than a general basis. These agencies also believe that the President has adequate existing authority to negotiate and that one-way authority to grant concessions in other sectors would not be particularly useful.

Other agencies believe that we need the additional authority to open telecommunications markets other than Japan. They argue that the only negotiating leverage we currently have is threatening to close the U.S. market unless other countries agree to unilaterally open their markets. This "negative negotiating leverage" alone is of limited utility because many nations (i.e., the

European Community at present) stand to lose little if the U.S. market is closed to them. The Danforth bill improves this situation by giving the President "positive negotiating leverage"; that is, the authority to grant U.S. concessions in a telecommunications trade agreement. This gives the President a clear legislative mandate to negotiate.

2nd Issue: If the Administration wants additional, sector-specific negotiating authority, can it accept some limit on Presidential discretion in deciding whether and when to retaliate as a trading chip with Congress to get the authority?

This is an important issue to Senator Danforth and the business community because they are convinced that the President will never retaliate unless he is required to by law. No agency supports the limits currently included in the bill. However, some would accept, rather than mandatory retaliation, the requirement that the President report to the Congress in writing on how he uses all the authorities that would be granted to him in the bill. Other agencies believe that we should not compromise on this issue at all.

3rd Issue: If the Administration wants additional, sector-specific negotiating authority, can it accept required sector reciprocity (i.e., SECO) as the principal negotiating objective as a trading chip with Congress to get the authority?

This issue is not as critical to Senator Danforth and the business community as the second issue is. No agency supports required SECO or SECO defined as the mirror image of the U.S. market. SECO in this context would constitute strict sectoral reciprocity and hence would be contrary to the Administration's trade policy. But, the Administration has already accepted SECO as one of many negotiating objectives we should try to achieve. SECO is a major objective in the MOSS negotiations with Japan and was accepted by the Administration as a general negotiating objective in the 1984 trade act.

4th Issue: What would be the impact of the Administration's position on development of the telecommunications market?

If the Administration opposes the Danforth bill, the U.S. business community and our trading partners will infer that we are not serious about opening foreign markets. This will diminish the likelihood of succeeding in our efforts to expand U.S. exports, and the trade deficit in telecommunications will likely continue to increase well beyond \$2 billion. On the other hand, if the Administration supports the bill and it is enacted, the President will probably end up retaliating against some nation, probably the European Community, which will likely counter-retaliate. The result will be a more restricted world market in telecommuni-

to the detriment of consumer welfare worldwide. Approximately \$50 billion in telecommunications equipment was purchased worldwide last year, about 40 percent (i.e., \$20 billion) of which was purchased in the United States.

OPTIONS

The Administration essentially has three options.

Option 1: Support the Bill

Under this approach, the EPC would recommend supporting the Bill with small technical changes.

Rationale

The President has little negotiating leverage to use to open foreign telecommunications markets. Therefore, he needs the powerful leverage created by automatic denial of access to the U.S. market if countries fail to open their markets to U.S. equipment and services. In addition it is highly unlikely that the President will be able politically to offer concessions affecting other sectors to gain access on telecommunications. The Congress would be unlikely to approve an agreement which includes such a transparent trade-off.

Advantage

- o Sends unequivocal message to the Japanese, the EC, and Canada that the United States is serious about achieving access to their telecommunications markets.

Disadvantages

- o Limits Presidential and USTR discretion.
- o Would require the Administration to determine publicly whether other nations are granting U.S. firms SECO in telecommunications. Given current conditions, we would probably have to identify most of our major trading partners as denying U.S. firms SECO or face serious credibility problems with Congress and our trading partners.
- o Probably would lead to counter-retaliation by at least some affected countries if we did retaliate, leading to a more restricted markets (both telecommunications and others) to the detriment of consumer welfare worldwide.
- o Elevates telecommunications to an unwarranted level of priority in light of overall U.S. trade interests.

- o Sets the Administration's trade policy off on a course of bilateral sectoral reciprocity.

Option 2: Oppose the Bill

In recommending this option, the EPC would make the fundamental philosophical decision that the Administration does not want to need additional, sector-specific negotiating authority on telecommunications.

Rationale

The President already has adequate negotiating authority. The Danforth bill is therefore unnecessary. The bill limits current Presidential discretion by: (1) requiring the President to engage in sector specific negotiations on telecommunications, thereby giving telecommunications priority over other sectors; (2) mandating retaliation when negotiations fail, regardless of other U.S. interests; and (3) delegating current Presidential Section 301 authority to USTR. The legislation could set a trade policy precedent for a series of sectoral trade laws rather than general negotiating authority.

Advantages

- o Avoids codifying a policy of sectoral reciprocity with each nation in telecommunications and the negative trade implications of such a policy.
- o Avoids limiting the President's discretion with respect to taking retaliatory action against countries.

Disadvantages

- o May well antagonize the Congress and the business community, thereby giving impetus to more troublesome legislation or expediting the pace of the Danforth bill.
- o Unless carefully handled, opposition to the bill could reduce our leverage in negotiations with Japan, and the EC and Canada may infer that the Administration is not very serious about opening those markets.

Option 3: Support Legislation That Provides Sector-Specific Negotiating Authority in Telecommunications But Does Not Limit Current Presidential Discretion

In recommending this option, the EPC would decide that the Administration wants additional negotiating authority on telecommunications and will consider a modified version of the Danforth bill as a vehicle for getting that authority.

Rationale

The United States has a serious trade problem in telecommunications. Ours is the only totally open telecommunications market in the world, and we are running a significant and sharply increasing deficit in this sector. Since 1982, our sectoral trade balance has decreased from a \$300 million surplus to a \$1.2 billion deficit. This is particularly troubling because our telecommunications products are in fact highly competitive. Other markets are restricted, and the existing international trade regime provides no avenue to achieve an equitable balance of market opportunities. A bill which increases the President's negotiating authority without limiting the President's discretion would add to the leverage of our negotiators to overcome foreign market barriers. Rather than mandating retaliation, the Congress could provide such new authority and ask the President to report on how it had been used. It appears that the Administration has a reasonable prospect for working out such a compromise with Senator Danforth and the industry.

Advantages

- o Could provide significant leverage in market access negotiations.
- o Is consistent with the Administration's decision to make telecommunications a high priority in negotiations with Japan.
- o Avoids a backlash in Congress and in the business community.

Disadvantages

- o Not clear that new authority would substantially improve the outlook for market access.
- o Could be construed as putting telecommunications ahead of all other trade issues.
- o May lead to demands for equal treatment by other sectors.
- o Some agencies believe that choosing this option would commit the Administration to work on a bill whose premise -- bilateral, sectoral reciprocity or retaliation -- is contrary to the Administration's trade policy.